























**NORTH STATE BANCORP**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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**NOTE A - ORGANIZATION AND OPERATIONS**

On June 28, 2002, North State Bancorp (the “Company”) was formed as a holding company for North State Bank (the “Bank”). Upon formation, one share of the Company’s \$1.00 par value common stock was exchanged for each of the outstanding shares of the Bank’s \$5.00 par value common stock. On May 9, 2007, the Company’s shareholders approved the decrease of the Company’s par value of common stock from \$1.00 per share to no par value per share. The Company currently has no operations and conducts no business on its own other than owning the Bank, North State Statutory Trust I, North State Statutory Trust II and North State Statutory Trust III, all of which are wholly owned by the Company. The Company is subject to the rules and regulations of the Federal Reserve Bank and the North Carolina Commissioner of Banks. During 2015, the Company’s Board of Directors approved a plan of reorganization providing for the reorganization of the Company’s ownership that would permit the Company to qualify for an election under Subchapter S of the Internal Revenue Code of 1986 (“IRC”).

The Bank was incorporated May 25, 2000, and began banking operations on June 1, 2000. The Bank is engaged in general commercial and retail banking in central North Carolina, principally Wake County, and in southeast North Carolina in New Hanover County, operating under the banking laws of North Carolina and the rules and regulations of the Federal Reserve Bank and the North Carolina Commissioner of Banks. The Bank undergoes periodic examinations by those regulatory authorities. The Bank’s wholly owned subsidiary, North State Wealth Advisors, Inc., offers wealth management and brokerage services. North State Bank Mortgage (“NSB Mortgage”), a division of the Bank, began operations during February 2010 for the purpose of originating and selling single-family, residential first mortgage loans. During 2016, the Bank established a small business lending services division. A significant portion of the loans originated (generally 75%) are guaranteed by the Small Business Administration (“SBA”) under the 7(a) Loan Program. At management’s discretion, the guaranteed portion of these 7(a) loans is sold in the secondary market. In October of 2017, the Bank’s wholly owned subsidiary, North State Title, LLC purchased a 5% interest in North Carolina Title Center, LLC, a title insurance agency.

**NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Basis of Presentation***

The accompanying consolidated financial statements include the accounts and transactions of North State Bancorp and its wholly owned subsidiary North State Bank. All significant intercompany transactions and balances are eliminated in consolidation. North State Bancorp and its subsidiary are collectively referred to herein as the “Company”.

Under Financial Accounting Standards Board (“FASB”) accounting standards for the consolidation of variable interest entities, North State Statutory Trust I, North State Statutory Trust II and North State Statutory Trust III are not included in the Company’s consolidated financial statements. The junior subordinated debentures issued by the Company to the three Trusts are included in long-term borrowings and the Company’s equity interest in the three Trusts is included in other assets.

***Use of Estimates***

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses and valuation of foreclosed assets.

***Cash and Cash Equivalents and Certificates of Deposit with Other Banks***

For presentation purposes in the consolidated statements of cash flows, cash and cash equivalents include cash and due from banks and interest-earning deposits with banks (including certificates of deposit with other banks). As discussed in Note I - Borrowings, the Company’s long-term FHLB advances are secured by cash of \$850,000 and short-term repurchase agreements are secured by cash of \$1 million. Certificates of deposit with other banks have a maturity of April 24, 2023 and bear an interest rate of 0.4%. All investments in certificates of deposit are with FDIC insured financial institutions and none exceed the maximum insurable amount of \$250 thousand.

***Investment Securities***

Available for sale securities are reported at fair value and consist of mortgage-backed securities not classified as trading securities or as held to maturity securities. Unrealized holding gains and losses on available for sale securities are reported in other comprehensive income. Gains and losses on the sale of available for sale securities are determined using the specific-identification method and are recorded in other noninterest income. Bonds for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for premiums and discounts that are recognized in interest income using a method that approximates the interest

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method over the period to maturity. Declines in the fair value of available for sale and held to maturity securities below their cost that are other than temporary would result in write-downs of the individual securities to their fair value. If the Company does not intend to sell the security prior to recovery and it is more likely than not the Company will not be required to sell the impaired security prior to recovery, the credit loss portion of the impairment is recognized in earnings and the remaining impairment is recognized in other comprehensive income. Otherwise, the full impairment loss is recognized in earnings. The classification of securities is generally determined at the date of purchase.

Certain equity security investments that do not have readily determinable fair values and for which the Company does not exercise significant influence are carried at cost. The Company has investments in the stock of the Federal Home Loan Bank of Atlanta (“FHLB”) and the Federal Reserve Bank (“FRB”) as a requirement for membership. All the equity securities are reviewed for impairment at least annually or sooner if events or changes in circumstances indicate the carrying value may not be recoverable. As of December 31, 2021 and 2020, the stock in these equity securities totaled \$1.6 million and \$1.9 million, respectively. Due to redemption provisions, the Company estimates that fair value equals cost.

***Loans Held for Sale***

Mortgage loans held for sale represent single-family, residential first mortgage loans on a pre-sold basis originated by our mortgage division. Generally, commitments to sell these loans are made after the intent to proceed with mortgage applications are initiated with borrowers, and all necessary components of the loan are approved according to secondary market underwriting standards of the investor that purchases the loan. Upon closing, these loans, together with their servicing rights, are sold to mortgage loan investors under prearranged terms. Loans held for sale are subsequently measured at the lower of cost or estimated fair value on an aggregated basis within the consolidated balance sheet under the caption “loans held for sale”. The Company recognizes certain origination and service release fees from the sale, which are included in fees from mortgage operations.

The Company is exposed to certain risks relating to its ongoing mortgage origination business. The Company primarily enters into a best-efforts contract with mortgage loan investors under which the Company will deliver individual mortgage loans. Under a best-efforts contract, the Company is not contractually obligated to deliver a maximum principal amount of mortgage loans and is not required to pay a “pair off” fee on any delivery shortfall. Because the best-efforts contract does not have a specified underlying or determinable notional amount or does not require net settlement, the contract does not meet the definition of a derivative. The period of time between the issuance of a loan commitment and the closing and sale of the loan generally ranges from 30 to 60 days. Such interest rate lock commitments represent derivative instruments which are required to be carried at fair value. These derivative instruments do not qualify as hedges under the Derivatives and Hedging topic of the FASB Accounting Standards Codification.

The Company also will enter into mandatory delivery contracts with mortgage loan investors where the Company commits to deliver a specified principal amount of mortgage loans to an investor at a specified price on or before a specified date. Failure to deliver the amount of mortgages necessary to fulfill the commitment by the specified date could result in the Company being obligated to pay a “pair off” fee, (depending on market conditions at the specified time of delivery, the investor may not charge a pair off fee). Based on these characteristics, the mandatory delivery contract meets the definition of a derivative at the time the Company enters the contract. The Company had \$2.4 million of open mandatory delivery commitments as of December 31, 2021.

The fair value of interest rate lock commitments is based on servicing rate premium, origination income net of origination costs, and changes in loan pricing between the commitment date and period end, typically month end. The gains and losses from the future sales of the mortgages are recognized when the Company and the borrower enter into the interest rate lock commitment and the resulting gain or loss is recorded in fees from mortgage operations.

***Loans***

Originated commercial and retail loans for which management has the intent and ability to hold for the foreseeable future are classified as held for investment and carried at the principal amount outstanding net of any unearned income, charge-offs and unamortized fees and costs. Nonrefundable fees collected and certain direct costs incurred related to loan originations are deferred and recorded as an adjustment to loans outstanding. The net amount of the nonrefundable fees and costs is amortized to interest income over the contractual lives using methods that approximate a constant yield. Interest income is recorded as earned on an accrual basis.

The Company provides loans guaranteed by the U.S. Small Business Administration (“SBA”) for the purchase of businesses, business startups, business expansion, equipment, and working capital. All SBA loans are underwritten and documented as prescribed by the SBA. SBA loans are generally fully amortizing and have maturity dates and amortizations of up to 25 years. SBA loans may be originated and held for interest income purposes or, at management’s discretion, the portion of SBA loans that are guaranteed can be sold at a gain in the secondary market. If a guaranteed portion of an SBA loan is sold, the servicing rights are retained. The portion of

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SBA loans that are retained (the unguaranteed portion) are also adjusted for a retained discount to reflect the effective interest rate on the retained unguaranteed portion of the loans if a sale takes place. Additionally, the Company defers direct origination costs on these loans. When a guaranteed portion of a loan is sold, the guaranteed portion of the deferred cost is recognized in the income statement as a reduction to the overall gain on sale as well as an increase in the retained discount. The remaining deferred cost on the unguaranteed portion amortizes into interest income in a manner which reflects the effective interest rate on the retained unguaranteed portion of the loan. The net value of the retained loans is included in the appropriate loan classification for disclosure purposes. These loans are primarily commercial real estate or commercial and industrial.

The Small Business Administration Paycheck Protection Program (“PPP”) is central to the Coronavirus Aid Relief and Economic Security Act (the “CARES Act”), which was passed on March 27, 2020 (“Round 1”), in response to the outbreak of coronavirus (“COVID-19”) and was supplemented with subsequent legislation. Overseen by the United States Treasury Department, the program offers cash-flow assistance to nonprofit and small business employers through guaranteed loans for expenses incurred between prescribed dates. Borrowers are eligible for forgiveness of principal and accrued interest on PPP loans to the extent that the proceeds were used to cover eligible payroll costs, interest costs, rent, and utility costs over a period of between eight and 24-weeks after the loan is made if the borrower retains its employees and their compensation levels. The CARES Act authorized the SBA to temporarily guarantee these loans. The SBA began processing forgiveness payments during the fourth quarter of 2020. The Consolidated Appropriations Act 2021 was signed into law during the fourth quarter of 2020 and contained provisions for a second round of funding of SBA-PPP loans (“Round 2”). The Company participated in both rounds of PPP. PPP loan origination fee income is capitalized into the carrying amount of the loans and is deferred and recognized over the life of the loan (or up unto forgiveness, whichever comes first) and accrete into interest income using the effective interest method.

Unsecured loans are charged-off against the Company’s allowance for loan losses as soon as the loan becomes uncollectible. Unsecured loans are considered uncollectible when no regularly scheduled monthly payment has been made within three months and the analysis of the borrower and any guarantors would indicate no further support can be provided, the loan matured over 90 days ago and has not been renewed or extended or the borrower files for bankruptcy. Secured loans are considered uncollectible when the liquidation of collateral is deemed to be the most likely source of repayment and the collateral or guarantors are deemed unable to repay any shortfall. Once secured loans reach 90 days past due, they are placed into non-accrual status. If the loan is deemed to be solely collateral dependent, the principal balance is written down immediately to reflect the current market valuation based on current independent appraisal/evaluation. Included in the write-down is the estimated expense to liquidate the property and typically an additional allowance for the foreclosure discount. Generally, if the loan is unsecured the loan must be charged-off in full while if it is secured the loan is charged down to the net liquidation value of the collateral.

Loans, including impaired loans, are generally classified as nonaccrual if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-secured and in the process of collection. Loans that are current or past due less than 90 days may also be classified as nonaccrual if repayment in full of principal and/or interest is in doubt (as determined by the contractual terms of the note). Loans may be returned to accrual status when all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within an acceptable period of time, and there is a sustained period of repayment performance (generally a minimum of six months) by the borrower, in accordance with the contractual terms.

While a loan (including an impaired loan) is classified as nonaccrual and the future collectability of the recorded loan balance is doubtful, collections of interest and principal are generally applied as a reduction to the principal outstanding. When the future collectability of the recorded loan balance is not in doubt, interest income may be recognized on a cash basis. In the case where a nonaccrual loan had been partially charged-off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded loan balance at the contractual interest rate. Receipts in excess of that amount are recorded as recoveries to the allowance for loan losses until prior charge-offs have been fully recovered.

Troubled Debt Restructurings (“TDRs”) are loans that have been modified due to deterioration in the borrower’s financial condition, resulting in more favorable terms for the borrower. Accrual of interest is continued for restructured loans when the borrower was performing prior to the restructuring and there is reasonable assurance of repayment and continued performance under the modified terms. Accrual of interest on restructured loans in nonaccrual status is resumed when the borrower has established a sustained period of performance under the restructured terms of at least six months.

***Allowance for Loan Losses***

The provision for loan losses is based upon management’s estimate of the amount needed to maintain the allowance for loan losses at an adequate level. In evaluating the allowance for loan losses, the Company prepares an analysis of its current loan portfolio using

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historical loss rates, other identified factors, and data from its portfolio to calculate a general reserve for loan losses. The Company applies a charge-off rate based on charge-off history applied to twelve classes of loans in its current loan portfolio. In addition, the Company has identified seven factors that are considered as indicators of changes in the level of risk of loss inherent with the Company's loan portfolio. These factors are payment performance, overall portfolio quality utilizing weighted average risk rating, general economic factors such as unemployment, delinquency and charge-off rates, regulatory examination results, the interest rate environment, levels of highly leveraged transactions and levels of commercial real estate concentrations, which address the risks associated with construction, development and non-owner occupied commercial real estate lending. Each of these factors is assigned a level of risk and this risk factor is applied to only the general pool of loans. In addition to the general reserve calculation, all loans risk rated "substandard", "doubtful" and "loss" are reviewed for probable losses. If management determines a loan to be impaired, it is removed from its homogeneous group and individually analyzed for impairment. Other groups of loans may also be selected for impairment review. A loan is considered impaired when, based on current information and events, it is considered probable that the Company will be unable to collect the scheduled payments of principal and interest when due according to the original contractual terms of the loan agreement. The measurement of impaired loans is generally based on the present value of expected future cash flows discounted at the original effective interest rate, or upon the fair value of the collateral if the loan is collateral dependent. If the recorded investment in the loan exceeds the measure of fair value, a valuation allowance is established as a component of the allowance for loan losses.

While management uses the best information available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the assumptions used in making the evaluations. In addition, regulatory examiners may require the Company to recognize adjustments to the allowance for loan losses based on their judgments about information available to them at the time of their examination.

***Premises and Equipment***

Premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on the straight-line method over the estimated useful lives of the assets which are 3 to 10 years for furniture and equipment and 30 to 40 years for buildings. Leasehold improvements are amortized over the terms of the respective leases or the estimated useful lives of the improvements, whichever is shorter. Repairs and maintenance costs are charged to operational expense as incurred and additions and improvements to premises and equipment are capitalized. Upon sale or retirement, the cost and related accumulated depreciation are removed from the accounts and any gains or losses are reflected in current operations. Long-lived depreciable assets are evaluated periodically for impairment when events or changes in circumstances indicate the carrying amount may not be recoverable.

***Foreclosed Assets***

Assets acquired through, or in lieu of, foreclosure are held for sale and are initially recorded at fair value less anticipated selling costs at the date of foreclosure, establishing a new cost basis. Principal and interest losses existing at the time of acquisition of such assets are charged against the allowance for loan losses and interest income, respectively. The initial recorded value may be subsequently reduced by additional valuation allowances, which are charged to earnings if the estimated fair value of the property less estimated selling costs declines below the initial recorded value. Costs related to the improvement of the property are capitalized, whereas those related to holding the property are expensed. Revenue and expenses from operations and changes in the valuation allowance are included in other expenses. The Company did not have any foreclosed assets as of December 31, 2021 and 2020. As of December 31, 2021, there were no loans in process of foreclosure. As of December 31, 2020, there were two loans totaling approximately \$119,000 in unpaid principal balance that were in process of foreclosure.

***Bank Owned Life Insurance***

Bank owned life insurance is carried at cash surrender value as determined by the insurer. The carrying value of life insurance approximates fair value.

***Income Taxes***

During 2015 the Company's Board of Directors approved a plan of reorganization providing for the reorganization of the Company's ownership that would permit the Company to qualify for an election under Subchapter S of the Internal Revenue Code of 1986 ("IRC"). The change in tax election enables the Company to take advantage of the favorable tax treatment afforded such entities under amendments to the IRC contained in the Small Business Jobs Protection Act of 1996 and subsequent amendments. The effect of an S Corporation election is to eliminate one level of taxation. Under an S Corporation election, corporate income, gains, and losses are passed through to the shareholders and each shareholder's pro rata share of Company income is reported on the shareholders' returns whether or not any cash or property is actually distributed to shareholders. The Company was approved for Subchapter S status with the Internal Revenue Service effective date of January 1, 2016.

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***SBA Servicing Assets***

All sales of SBA-guaranteed loans are executed on a servicing retained basis, and the Company retains the rights and obligations to service the loans. The standard sale structure under the SBA Secondary Participation Guaranty Agreement provides for the Company to retain a portion of the cash flow from the interest payment received on the loan. This cash flow is commonly known as a servicing spread. SBA regulations require the lender to retain a minimum 100 basis points in servicing spread for any guaranteed loan sold for a premium. The minimum servicing spread is further defined as a minimum service fee of 40 basis points and a minimum premium protection fee of 60 basis points. The servicing spread is recognized as a servicing asset to the extent the spread exceeds adequate compensation for the servicing function. Industry practice recognizes adequate compensation for servicing SBA loans as the minimum service fee of 40 basis points. The fair value of the servicing asset is measured at the discounted present value of the premium protection fee over the expected life of the related loan using appropriate discount rates and prepayment assumptions based on industry statistics. SBA servicing assets are initially recognized at fair value and amortized over the expected life of the related loans using the level yield method as a reduction of the servicing income recognized from the servicing spread. The servicing rights are periodically evaluated for impairment based upon the fair value of the rights as compared to carrying amount. If a temporary impairment exists, the servicing asset is written down through a valuation allowance and is charged against servicing income. Loans serviced for others are not included in the consolidated balance sheets. There was no valuation allowance required to be established as of December 31, 2021, or 2020, respectively.

***Earnings Per Common Share***

Basic earnings per share represent income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. The Company did not have any potential dilutive common shares for the years ended December 31, 2021 and December 31, 2020.

***Debt Issuance Costs***

Incremental costs directly incurred to issue the Company's subordinated debt are recorded, net of cumulative amortization, on the Company's consolidated balance sheets as a direct reduction of the carrying value of the related debt.

***Comprehensive Income***

Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in net income. Certain changes in assets and liabilities, such as unrealized gains and losses on investment securities available for sale and unrealized holding gains on hedge instruments are reported as a separate component of the equity section of the balance sheet. Such items, along with net income, are components of total comprehensive income. The Company's only component of accumulated other comprehensive income was unrealized gains and losses on available for sale securities.

***Derivative Instruments***

The Company's deposit and loan activities are vulnerable to interest rate risk. The associated variability in cash flows may impact the results of operations of the Company. The Company's hedging strategy is generally intended to take advantage of opportunities to reduce, to the extent possible, unpredictable cash flows. The Company may employ a variety of common derivative products that are instruments used by financial institutions to manage interest rate risk. The financial instruments that may be used as part of a hedging strategy include swaps, caps, floors, and collars.

The Company does not enter into derivative financial instruments for speculative or trading purposes. Through its mortgage operations, the Company does enter into interest rate lock commitments. Such interest rate lock commitments represent derivative instruments which are required to be carried at fair value and recorded as other assets.

***Segment Reporting***

Management is required by accounting pronouncements governing the disclosures about segments of an enterprise and related information to report selected financial and descriptive information about reportable operating segments. It also establishes standards for related disclosures about products and services, geographic areas, and major customers. Generally, disclosures are required for segments internally identified to evaluate performance and resource allocation. Included as a division of the Bank, NSB Mortgage and our SBA division are reported as separate segments as well as the parent Company. Segment information regarding the Bank, NSB Mortgage, SBA and the parent Company are fully described in Note Q. The Company has no foreign operations or customers.

***Revenue Recognition***

Management is required by accounting pronouncements governing the recognition of revenue which require an entity to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the Company expects to be entitled in exchange for those goods or services.

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**Subsequent Events**

The Company has evaluated subsequent events through March 23, 2022.

**Recently Issued Accounting Pronouncements**

*FASB ASU 2021-08 – Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers:* This ASU was issued to improve the accounting for acquired revenue contracts with customers in a business combination. Under current GAAP, an acquirer generally recognizes contract assets acquired and contract liabilities assumed in a business combination at the acquisition date fair value. This ASU will now require an acquirer to recognize and measure contract assets acquired and contract liabilities assumed in a business combination in accordance with FASB Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, as if it had originated the contracts. The effective date for this guidance is for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. The ASU should be applied prospectively to business combinations occurring on or after the effective date of the amendments. The Company does not anticipate that the impact the adoption this guidance will have on its consolidated financial statements will be material.

*FASB ASU 2021-01 – Reference Rate Reform (Topic 848):* The amendments in this Update clarify that certain optional expedients and exceptions in Topic 848 for contract modifications and hedge accounting apply to derivatives that are affected by the discounting transition. Specifically, certain provisions in Topic 848, if elected by an entity, apply to derivative instruments that use an interest rate for margining, discounting, or contract price alignment that is modified as a result of reference rate reform. Amendments in this Update to the expedients and exceptions in Topic 848 capture the incremental consequences of the scope clarification and tailor the existing guidance to derivative instruments affected by the discounting transition. The effective date for this guidance is upon issuance. The Company is currently evaluating the impact the adoption this guidance will have on its consolidated financial statements.

*FASB ASU 2020-08 – Codification Improvements to Subtopic 310-20, Receivables—Nonrefundable Fees and Other Costs:* The amendments in this ASU clarify that an entity should reevaluate whether a callable debt security is within the scope of paragraph 310-20-35-33 for each reporting period. The amendments in this ASU affect the guidance in ASU 2017-08, *Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities*. The effective date for this guidance is for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. The Company is currently evaluating the impact the adoption this guidance will have on its consolidated financial statements.

*FASB ASU 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments:* In June 2016, the FASB issued new guidance that replaces the incurred loss impairment methodology in current standards with an expected credit loss methodology and requires consideration of a broader range of information to determine credit loss estimates. The guidance requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts and requires enhanced disclosures related to the significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. In addition, the guidance amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The guidance will be effective for the Company for the years beginning after December 15, 2022, including interim periods within those fiscal years. The Company is currently evaluating the effect the implementation of the new standard will have on its consolidated financial statements.

*FASB ASU 2016-02, Leases (Topic 842):* In February 2016, the FASB issued new guidance related to Leases which will require lessees to record as an asset on the balance sheet the right to use the leased asset and a liability for the corresponding lease obligation for leases with terms of more than 12 months. The accounting treatment for lessors will remain relatively unchanged. The guidance also requires additional qualitative and quantitative disclosures related to the nature, timing and uncertainty of cash flows arising from leases. The effective date for this guidance is for fiscal years beginning after December 15, 2021, and interim periods within annual periods beginning after December 15, 2022. Early adoption is permitted. The Company adopted this guidance on January 1, 2022. The adoption of Topic 842 resulted in the establishment of \$2.8 million in right of use assets and \$2.9 million in right of use liabilities related to the two operating leases and one finance lease that were identified during the adoption process.

Other accounting standards that have been issued by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

**Recently Adopted Accounting Pronouncements**

*FASB ASU 2018-15 – Intangibles – Goodwill and Other- Internal-Use Software (Subtopic 350-40):* This ASU amends and improves current guidance on accounting for implementation costs of a hosting arrangement that is a service contract. The amendments in this



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update align the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). The effective date for this guidance is for fiscal years beginning after December 15, 2020, and interim periods within annual periods beginning after December 15, 2021. The Company adopted this guidance on January 1, 2021, which did not have a material impact on its consolidated financial statements.

*FASB ASU 2021-03 - Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment:* This ASU was issued in order to simplify the subsequent measurement of goodwill by eliminating the Step 2 goodwill impairment test. Under the amendments in this ASU, an entity should perform its annual or interim goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity will then recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value, however the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. Additionally, an entity should consider income tax effects from any tax-deductible goodwill on the carrying amount of the reporting unit when measuring the goodwill impairment loss, if applicable. The amendments in this ASU also eliminated the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and therefore the same impairment assessment now applies to all reporting units. An entity is required to disclose the amount of goodwill allocated to each reporting unit with a zero or negative carrying amount of net assets. The ASU did not affect the option to perform the qualitative assessment (Step 0) for a reporting unit to determine if the quantitative impairment test is necessary and private companies will still have the option to elect the PCC alternative on goodwill. The effective date for this guidance is for fiscal years beginning after December 15, 2019. The Company adopted this guidance on January 1, 2020, which did not have a material impact on its consolidated financial statements.

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**NOTE C - INVESTMENT SECURITIES**

The following table presents the amortized cost and fair value of securities available for sale and securities held to maturity with gross unrealized gains and losses as of December 31, 2021, and 2020, respectively.

	As of December 31, 2021			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
	<i>(Dollars in thousands)</i>			
Securities available for sale:				
Government-sponsored residential mortgage- backed securities	\$ 4,283	\$ 8	\$ 39	\$ 4,252
Total securities available for sale	<u>\$ 4,283</u>	<u>\$ 8</u>	<u>\$ 39</u>	<u>\$ 4,252</u>
Securities held to maturity:				
Corporate bonds	\$ 2,250	\$ 12	\$ 35	\$ 2,227
Municipal bonds	41,311	854	188	41,977
Total securities held to maturity	<u>\$ 43,561</u>	<u>\$ 866</u>	<u>\$ 223</u>	<u>\$ 44,204</u>
	As of December 31, 2020			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
	<i>(Dollars in thousands)</i>			
Securities available for sale:				
Government-sponsored residential mortgage- backed securities	\$ 1,105	\$ 13	\$ -	\$ 1,118
Total securities available for sale	<u>\$ 1,105</u>	<u>\$ 13</u>	<u>\$ -</u>	<u>\$ 1,118</u>
Securities held to maturity:				
Corporate bonds	\$ 750	\$ 5	\$ -	\$ 755
Municipal bonds	33,111	1,369	9	34,471
Total securities held to maturity	<u>\$ 33,861</u>	<u>\$ 1,374</u>	<u>\$ 9</u>	<u>\$ 35,226</u>

All unrealized losses on investment securities are considered by management to be temporary given the credit ratings on these investment securities and the Company's intent and ability to hold these securities to maturity. As of December 31, 2021, the Company's available for sale securities included two Government-sponsored residential mortgage-backed securities with unrealized losses of approximately \$39,000. The unrealized losses on held to maturity securities as of December 31, 2021 relate to twenty-nine tax-exempt municipal bonds; two corporate securities; and one taxable municipal bond with combined unrealized losses of approximately \$223,000. As of December 31, 2020, the Company's available for sale securities did not have any unrealized losses. The unrealized losses on held to maturity securities as of December 31, 2021 relate to three municipal bonds with unrealized losses of approximately \$9,000. All unrealized losses on investment securities are not considered to be other-than-temporary, because they are related to changes in interest rates, lack of liquidity and demand in the general investment market and do not affect the expected cash flows of the underlying collateral or the issuer. Since the Company does not intend to sell the municipal bonds with unrealized losses prior to maturity and it is more likely than not the Company will not be required to sell any of these securities in unrealized loss positions prior to maturity, they are not deemed to be other than temporarily impaired.

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The following table presents the gross unrealized losses on and fair values of the Company's investments as of December 31, 2021 and 2020, respectively, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position.

	As of December 31, 2021					
	Less than 12 months		12 months of more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	<i>(Dollars in thousands)</i>					
Securities available for sale:						
Government-sponsored residential mortgage-backed securities	\$ 4,252	\$ 39	\$ -	\$ -	\$ 4,252	\$ 39
Total temporarily impaired securities	<u>\$ 4,252</u>	<u>\$ 39</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 4,252</u>	<u>\$ 39</u>
Securities held to maturity:						
Corporate bonds	\$ 2,227	\$ 35	\$ -	\$ -	\$ 2,227	\$ 35
Municipal bonds	41,544	181	433	7	41,977	188
Total temporarily impaired securities	<u>\$ 43,771</u>	<u>\$ 216</u>	<u>\$ 433</u>	<u>\$ 7</u>	<u>\$ 44,204</u>	<u>\$ 223</u>
	As of December 31, 2020					
	Less than 12 months		12 months of more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	<i>(Dollars in thousands)</i>					
Securities available for sale:						
Government-sponsored residential mortgage-backed securities	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Total temporarily impaired securities	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
Securities held to maturity:						
Corporate bonds	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Municipal bonds	1,399	9	-	-	1,399	9
Total temporarily impaired securities	<u>\$ 1,399</u>	<u>\$ 9</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,399</u>	<u>\$ 9</u>

**NORTH STATE BANCORP**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**Years Ended December 31, 2021 and 2020**

The following table presents the amortized cost and fair values of securities available for sale and securities held to maturity as of December 31, 2021, by contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	<u>As of December 31, 2021</u>	
	<u>Amortized Cost</u>	<u>Fair Value</u>
	<i>(Dollars in thousands)</i>	
Securities available for sale:		
Government-sponsored residential mortgage-backed securities:		
Due after five but within ten years	\$ 739	\$ 746
Due after ten years	3,544	3,506
Total securities available for sale	<u>\$ 4,283</u>	<u>\$ 4,252</u>
Securities held to maturity:		
Corporate bonds:		
Due after five but within ten years	\$ 2,250	\$ 2,227
	<u>\$ 2,250</u>	<u>\$ 2,227</u>
Municipal bonds:		
Due within three months	\$ -	\$ -
Due after one but within five years	9,243	9,479
Due after five but within ten years	13,778	14,234
Due after ten years	18,290	18,264
	<u>\$ 41,311</u>	<u>\$ 41,977</u>
Total securities held to maturity:	<u>\$ 43,561</u>	<u>\$ 44,204</u>

No securities were pledged as of December 31, 2021 or 2020. There were no security sales during the years ended December 31, 2021 or 2020.

**NORTH STATE BANCORP**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**Years Ended December 31, 2021 and 2020**

**NOTE D – LOANS**

The following table presents a summary of loans segregated by loan category as of December 31, 2021, and 2020.

	As of December 31,	
	2021	2020
	<i>(Dollars in thousands)</i>	
Real estate secured loans:		
Residential construction	\$ 47,073	\$ 45,051
Commercial construction, all land development and other land loans	51,505	46,701
Residential properties	139,798	118,575
Residential mortgage (1)	111,248	94,269
Commercial real estate - other	460,242	427,812
Total real estate secured loans	<u>809,866</u>	<u>732,408</u>
Other non-real estate loans and leases:		
Commercial and industrial	104,448	219,209
Consumer and other	3,668	3,247
Total loans held for investment	<u>\$ 917,982</u>	<u>\$ 954,864</u>
Single-family residential mortgages held for sale	<u>\$ 7,218</u>	<u>\$ 27,500</u>

(1) Single-family residential mortgages originated through NSB Mortgage held for investment.

Loans are primarily funded in Wake County and New Hanover County in North Carolina. Real estate loans can be affected by the condition of the local real estate market. Commercial and installment loans can be affected by the local economic conditions. Included in the loan balances above are net unamortized loan costs of approximately \$2.9 million and \$370,000, respectively, as of December 31, 2021 and 2020. PPP loans are included in the 'Commercial and industrial' line item and totaled approximately \$5.3 million and \$97.8 million, respectively as of December 31, 2021 and 2020.

The following describes the risk characteristics relevant to each of the portfolio segments.

***Residential construction***

The Company provides financing to builders for the construction of speculative and pre-sold custom homes, and from time to time, financing for custom homes where the home buyer is the borrower. Residential construction loans typically are for periods of 12 months or less and the homes are sold to consumers who obtain permanent financing. The loans are underwritten utilizing independent appraisals, sensitivity analysis of absorption and financial analysis of the borrower.

***Commercial construction***

Commercial real estate construction and land development loans are also underwritten utilizing independent appraisals, sensitivity analysis of absorption and financial analysis of the general contractors and borrowers. Commercial construction loans are generally based upon estimates of costs and value associated with the as-completed project. These estimates may be inaccurate. The loans often involve the disbursement of substantial funds with the repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans or sales of developed property.

All construction loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, government regulation of real property, general economic conditions, and the availability of long-term financing.

**NORTH STATE BANCORP**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**Years Ended December 31, 2021 and 2020**

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***Residential properties***

Residential real estate secured loans are subject to underwriting based on the purpose of the loan. Residential real estate properties secured by income-producing property typically have a loan-to-value ratio of 85% or less. Residential real estate properties secured by the primary residence of the borrower typically have a loan-to-value ratio less than 90%. Also included are loans that are underwritten and secured by second liens and home equity lines of credit which are revolving extensions of credit that are secured by first or second liens on owner-occupied residential real estate.

***Residential mortgage***

Residential mortgage loans represent one-to-four family loans originated through NSB Mortgage and selected by the Company to be retained in its portfolio. These loans are subject to strict underwriting standards which, at a minimum, comply with Freddie Mac guidelines and have moderate loan-to-value ratios, typically less than 80% and with credit scores typically exceeding 720. In addition, the Company retains individual jumbo mortgages in excess of \$548,250 originated through NSB Mortgage with similar underwriting guidelines to above.

***Commercial real estate - other***

Commercial real estate secured loans are subject to underwriting standards that focus on proper loan to value and cash flow to meet debt service coverage requirements. Commercial real estate lending typically involves higher loan principal amounts, and the repayment of these loans is generally dependent on the successful operation of the property securing the loan or the lease income on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in real estate markets or the general economy. The properties securing the Company's commercial real estate portfolio are either owner occupied, or non-owner occupied. Owner-occupied properties include professional practices, retail establishments, service companies and churches. Non-owner-occupied properties include office, retail, industrial and multi-family rental properties. Management monitors and evaluates commercial real estate loans based on collateral, market area and risk grade criteria. The Company also utilizes third-party experts to provide insight and guidance about economic conditions and trends within its market areas.

***Commercial and industrial***

Non-real estate secured commercial and industrial loans are underwritten after evaluating and understanding the borrowers' ability to operate profitably and prudently expand its business. Underwriting standards are designed to promote relationship banking rather than transactional banking. Management examines current and projected cash flows of the borrower to determine the ability of the borrower to repay its obligation as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower and tertiary, as applicable, the guarantors. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable, inventory or equipment and usually incorporate a personal guarantee. In the case of loans secured by accounts receivable, the availability of the funds for repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. Included in commercial and industrial is a small lease portfolio. The primary risk associated with lease financing is the ability of borrowers to achieve business results consistent with those projected at origination. Failure to achieve these projections presents risk the borrower will be unable to service the debt consistent with the contractual terms of the lease. Additionally, SBA loans and PPP loans are included within this category.

***Consumer and other***

Consumer and other loans include automobile loans, boat, and recreational vehicle financing, other secured or unsecured loans and loans to tax exempt entities. Consumer loans generally carry greater risk than other loans, even if secured, if the collateral consists of rapidly depreciating assets such as automobiles and equipment. Consumer loan collections are sensitive to job loss, illness, and other personal factors. The Company manages risks inherent in consumer and other lending by following established credit guidelines and underwriting practices designed to minimize the risk of loans.

The Company maintains an independent loan review function that reviews and validates the credit risk program on a periodic basis. Results of these reviews are presented to management and the board of directors. The loan review process compliments and reinforces the risk identification and assessment decisions made by bankers and credit personnel, as well as the Company's policies and procedures.

The Company also originates single-family, residential mortgage loans that have been approved by investors in the secondary market which are included on the consolidated balance sheet under the caption "loans held for sale." The Company recognizes certain origination and service release fees from sale, which are included in non-interest income on the consolidated statements of operations. As of December 31, 2021, and 2020, loans held for sale were \$7.2 million and \$27.5 million, respectively.

**NORTH STATE BANCORP**  
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**Related party loans**

The Company engages in loan transactions with its directors and executive officers. Such loans were made in the ordinary course of business and on substantially the same terms and collateral requirements as those for comparable transactions prevailing at the time and did not involve more than the normal risk of collectability or present other unfavorable features.

The following table presents a roll-forward of related party loans for the years ending December 31, 2021, and 2020.

	2021	2020
	<i>(Dollars in thousands)</i>	
Balance, beginning of year	\$ 18,756	\$ 21,350
Additional borrowings	28,806	9,111
Loan repayments	(17,438)	(11,727)
Change in board members	3,084	22
Balance, end of year	<u>\$ 33,208</u>	<u>\$ 18,756</u>
Unused lines of credit	<u>\$ 17,081</u>	<u>\$ 7,014</u>

**Nonaccrual loans**

Nonaccrual loans as of December 31, 2021 were \$2.2 million compared to \$3.6 million as of December 31, 2020. The approximate amount of interest income foregone on nonaccrual loans during the year was \$191,000 and \$185,000 for the years ending December 31, 2021, and 2020, respectively.

**Past due loans**

The following table presents an aging analysis of past due loans segregated by loan class as of December 31, 2021, and 2020, respectively.

	As of December 31, 2021				Total Loans
	30 - 89 Days Past Due	Over 90 Days (1)	Total Past Due	Current	
	<i>(Dollars in thousands)</i>				
Real estate secured loans:					
Residential construction	\$ -	\$ -	\$ -	\$ 47,073	\$ 47,073
Commercial construction, all land development and land loans	-	-	-	51,505	51,505
Residential properties	30	-	30	139,768	139,798
Residential mortgage (2)	800	-	800	110,448	111,248
Commercial real estate - other	-	1,393	1,393	458,849	460,242
Total real estate secured loans	<u>830</u>	<u>1,393</u>	<u>2,223</u>	<u>807,643</u>	<u>809,866</u>
Other non-real estate loans and leases:					
Commercial and industrial	79	831	910	103,538	104,448
Consumer and other	-	-	-	3,668	3,668
Total	<u>\$ 909</u>	<u>\$ 2,224</u>	<u>\$ 3,133</u>	<u>\$ 914,849</u>	<u>\$ 917,982</u>

**NORTH STATE BANCORP**  
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	As of December 31, 2020				
	30 - 89 Days	Over 90	Total Past	Current	Total
	Past Due	Days (1)	Due		
	<i>(Dollars in thousands)</i>				
Real estate secured loans:					
Residential construction	\$ -	\$ -	\$ -	\$ 45,051	\$ 45,051
Commercial construction, all land development and land loans	-	-	-	46,701	46,701
Residential properties	-	468	468	118,107	118,575
Residential mortgage (2)	1,268	119	1,387	92,882	94,269
Commercial real estate - other	2,000	1,996	3,996	423,816	427,812
Total real estate secured loans	3,268	2,583	5,851	726,557	732,408
Other non-real estate loans and leases:					
Commercial and industrial	304	1,035	1,339	217,870	219,209
Consumer and other	-	-	-	3,247	3,247
Total	\$ 3,572	\$ 3,618	\$ 7,190	\$ 947,674	\$ 954,864

(1) All in nonaccrual status

(2) Single-family residential mortgages originated through NSB Mortgage, held for investment

**Impaired loans**

The following table presents information regarding impaired loans segregated by loan class as of and for the year ended December 31, 2021, and 2020, respectively.

	As of December 31, 2021				For the year ended December 31, 2021	
	Unpaid Principal Balance	Partial Charge-offs	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
		<i>(Dollars in thousands)</i>				
<b>Impaired with no related allowance recorded:</b>						
Real estate secured loans:						
Residential properties	\$ 200	\$ -	\$ 200	\$ -	\$ 202	\$ 8
Commercial real estate - other	1,147	-	1,147	-	1,179	-
Total real estate secured loans	1,347	-	1,347	-	1,381	8
Other non-real estate loans and leases:						
Commercial and industrial	\$ 1,766	\$ (868)	\$ 898	\$ -	\$ 956	\$ 4
Total impaired with no related allowance recorded	\$ 3,113	\$ (868)	\$ 2,245	\$ -	\$ 2,337	\$ 12
<b>Impaired with a related allowance recorded:</b>						
Real estate secured loans:						
Commercial real estate - other	\$ 246	\$ -	\$ 246	\$ 25	\$ 248	\$ -
Total real estate secured loans	246	-	246	25	248	-
Other non-real estate loans and leases:						
Total impaired with a related allowance recorded	\$ 246	\$ -	\$ 246	\$ 25	\$ 248	\$ -
<b>Total impaired</b>						
Commercial	\$ 3,159	\$ (868)	\$ 2,291	\$ 25	\$ 2,383	\$ 4
Residential	200	-	200	-	202	8
Total	\$ 3,359	\$ (868)	\$ 2,491	\$ 25	\$ 2,585	\$ 12



**NORTH STATE BANCORP**  
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	As of December 31, 2020				For the year ended December 31, 2020	
	Unpaid Principal Balance	Partial Charge-offs	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
	<i>(Dollars in thousands)</i>					
<b>Impaired with no related allowance recorded:</b>						
Real estate secured loans:						
Residential properties	\$ 467	\$ -	\$ 467	\$ -	\$ 468	\$ -
Residential mortgage (1)	119	-	119	-	118	-
Commercial real estate - other	2,149	(152)	1,997	-	2,151	17
Total real estate secured loans	2,735	(152)	2,583	-	2,737	17
Other non-real estate loans and leases:						
Commercial and industrial	\$ 3,140	\$ (2,105)	\$ 1,035	\$ -	\$ 1,911	\$ -
Total impaired with no related allowance recorded:	\$ 5,875	\$ (2,257)	\$ 3,618	\$ -	\$ 4,648	\$ 17
<b>Impaired with a related allowance recorded:</b>						
Other non-real estate loans and leases:						
Total impaired with a related allowance recorded:	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Total impaired</b>						
Commercial	\$ 5,289	\$ (2,257)	\$ 3,032	\$ -	\$ 4,062	\$ 17
Residential	586	-	586	-	586	-
Total	\$ 5,875	\$ (2,257)	\$ 3,618	\$ -	\$ 4,648	\$ 17

(1) Single-family residential mortgages originated through NSB Mortgage held for investment.

Each loan risk rated “substandard”, “doubtful” and “loss” is reviewed to determine if it is an impaired loan. If a loan is determined to be impaired, it is removed from its homogeneous group and individually analyzed for impairment. Other groups of loans based on facts and circumstances may also be selected for impairment review. If a loan is impaired, a specific reserve allowance is allocated if necessary. Interest payments on impaired loans are typically applied to principal. Impaired loans are charged off in full or in part when losses are confirmed.

As of December 31, 2021, the recorded investment in loans considered impaired totaled \$2.5 million. The Company provided specific reserves of \$25,000 for probable losses on impaired loan balances of \$246,000. Management analyzed \$2.2 million of impaired loans and determined the collateral to be adequate and no additional specific reserve allowance was necessary after recording approximately \$868,000 in life-to-date partial charge-offs. Total impaired loans as of December 31, 2021 include \$65,000 of restructured but still accruing loans and no restructured nonaccrual loans.

As of December 31, 2020, the recorded investment in loans considered impaired totaled \$3.6 million. The Company did not provide for specific reserves for probable losses on impaired loan balances as all impaired loans were deemed to be adequately collateralized under the Company’s policy. Management analyzed \$3.6 million of impaired loans and determined the collateral to be adequate and no additional specific reserve allowance was necessary after recording approximately \$2.3 million in life-to-date partial charge-offs. Total impaired loans as of December 31, 2020 include no restructured but still accruing loans and \$79,000 of restructured nonaccrual loans.

**Credit Quality Indicators**

As part of the on-going monitoring of the credit quality of the Company’s loan portfolio, management examines certain credit quality indicators which consider the risk of payment performance, overall portfolio quality utilizing weighted-average risk rating, general economic factors, net charge-offs, non-performing loans, and the level of classified loans. All loans risk rated “substandard”, “doubtful” and “loss” are reviewed on an individual basis for probable losses.

A description of our credit quality indicators follows:

Pass – loans with acceptable credit quality and moderate risk.

**NORTH STATE BANCORP**  
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Special mention – This grade is intended to be temporary and includes loans (1) with potential weaknesses if left uncorrected could result in deterioration or (2) classified as substandard accruing or substandard nonaccruing that have made improvements to their financial profile but do not yet meet the definition of a pass grade.

Substandard, accruing – These loans have a well-defined weakness where the accrual of interest has not been stopped. The defined weakness may make default or principal exposure likely but not certain. These loans are likely to be dependent on collateral liquidation or a secondary source of repayment.

Substandard, nonaccruing – These assets have well defined weakness that jeopardize the liquidation of the debt and are past due over 90 days. The institution may sustain loss if the weaknesses are not corrected. These loans are inadequately protected by the paying capacity of the borrower, any guarantors or of the collateral pledged. These loans are individually analyzed for impairment.

Doubtful – These loans have all the weaknesses of substandard, nonaccruing plus the added characteristic that the weaknesses make collection or liquidation in full based on currently existing facts, conditions and values, highly questionable and improbable.

Loss – These loans are considered uncollectable and of such little value that their continuance as a bankable asset is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off the asset even though partial recovery may be affected in the future.

The following table presents information regarding the Company’s credit risk by internally assigned risk grades as of December 31, 2021, and 2020, respectively.

	As of December 31, 2021							
	Real Estate Loans					Non-Real Estate Loans		Total
	Construction		Residential Properties	Residential Mortgage (1)	Commercial	Commercial & Industrial	Consumer & Other	
	Residential	Commercial						
	<i>(Dollars in thousands)</i>							
Pass	\$ 47,073	\$ 51,435	\$ 138,248	\$ 111,248	\$ 455,299	\$ 103,512	\$ 3,668	\$ 910,483
Special mention	-	70	1,550	-	3,550	105	-	5,275
Substandard nonaccruing	-	-	-	-	1,393	831	-	2,224
Total by exposure	<u>\$ 47,073</u>	<u>\$ 51,505</u>	<u>\$ 139,798</u>	<u>\$ 111,248</u>	<u>\$ 460,242</u>	<u>\$ 104,448</u>	<u>\$ 3,668</u>	<u>\$ 917,982</u>

  

	As of December 31, 2020							
	Real Estate Loans					Non-Real Estate Loans		Total
	Construction		Residential Properties	Residential Mortgage (1)	Commercial	Commercial & Industrial	Consumer & Other	
	Residential	Commercial						
	<i>(Dollars in thousands)</i>							
Pass	\$ 45,051	\$ 46,618	\$ 115,381	\$ 94,269	\$ 416,409	\$ 217,636	\$ 3,247	\$ 938,611
Special mention	-	83	2,607	-	9,407	538	-	12,635
Substandard nonaccruing	-	-	587	-	1,996	1,035	-	3,618
Total by exposure	<u>\$ 45,051</u>	<u>\$ 46,701</u>	<u>\$ 118,575</u>	<u>\$ 94,269</u>	<u>\$ 427,812</u>	<u>\$ 219,209</u>	<u>\$ 3,247</u>	<u>\$ 954,864</u>

(1) Single-family residential mortgages originated through NSB Mortgage, held for investment.

TDR loans generally occur when a borrower is experiencing, or is expected to experience, financial difficulties in the near-term. As a result, a concessionary modification with more favorable terms that would not otherwise be considered may be granted to the borrower with the intent to prevent further difficulties and improve the likelihood of recovery of the loan. The modifications resulting in a TDR have generally involved a reduction of interest rate or extension of term of the loan or a combination of both. We do not generally forgive principal as part of a loan modification. Also, when possible, additional collateral or guarantor support is obtained when modifying the loan. All TDRs are individually reviewed and analyzed for impairment during management’s monthly evaluation of the allowance for loan losses. The specific allowance is based on the present value of expected cash flows or the fair value of the collateral or the loan’s observable market price.

There was one modification made to a loan with an outstanding unpaid principal balance of \$65,000 that resulted in a new TDR during the year ending December 31, 2021. There were no modifications resulting in new TDRs during the year ending December 31, 2020. Additionally, there were no TDR defaults during the last twelve months.

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On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) was signed into law. Section 4013 of the CARES Act, "Temporary Relief from Troubled Debt Restructurings," provides banks the option to temporarily suspend certain requirements under U.S. GAAP related to troubled debt restructurings (TDR) for a limited period of time to account for the effects of COVID-19. The Company elected this guidance during 2021 and 2020. There was approximately \$354,000 and \$13.1 million in outstanding unpaid principal balance of Section 4013 loans as of December 31, 2021 and 2020, respectively. The temporary relief provided by Section 4013 lapsed as of January 1, 2022.

**NOTE E - ALLOWANCE FOR LOAN LOSSES**

The following table presents activity in the allowance for loan losses by loan category for the years ended December 31, 2021, and 2020, respectively. Allocation of a portion of the allowance to one class of loan does not preclude its availability to absorb losses in other classes. For both 2021 and 2020, PPP loans are included within the Commercial & Industrial column.

	As of and for the Year Ended December 31, 2021							
	Real Estate Loans					Non-Real Estate Loans		Total
	Construction		Residential	Residential	Commercial	Commercial &	Consumer &	
	Residential	Commercial	Properties	Mortgage (1)		Industrial	Other	
	<i>(Dollars in thousands)</i>							
<b>Allowance for loan losses:</b>								
Beginning balance	\$ 294	\$ 279	\$ 799	\$ 791	\$ 3,074	\$ 1,205	\$ 76	\$ 6,518
Charge-offs	-	-	-	(40)	(272)	(267)	-	(579)
Recoveries	-	-	-	24	100	677	2	803
Provision (recovery)	-	-	-	-	-	-	-	-
Ending balance	<u>\$ 294</u>	<u>\$ 279</u>	<u>\$ 799</u>	<u>\$ 775</u>	<u>\$ 2,902</u>	<u>\$ 1,615</u>	<u>\$ 78</u>	<u>\$ 6,742</u>
Ending balance, individually evaluated for impairment	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 25</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 25</u>
Ending balance, collectively evaluated for impairment	<u>\$ 294</u>	<u>\$ 279</u>	<u>\$ 799</u>	<u>\$ 775</u>	<u>\$ 2,877</u>	<u>\$ 1,615</u>	<u>\$ 78</u>	<u>\$ 6,717</u>
<b>Loans:</b>								
Ending balance	<u>\$ 47,073</u>	<u>\$ 51,505</u>	<u>\$ 139,798</u>	<u>\$ 111,248</u>	<u>\$ 460,242</u>	<u>\$ 104,448</u>	<u>\$ 3,668</u>	<u>\$ 917,982</u>
Ending balance, individually evaluated for impairment	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 200</u>	<u>\$ -</u>	<u>\$ 1,393</u>	<u>\$ 898</u>	<u>\$ -</u>	<u>\$ 2,491</u>
Ending balance, collectively evaluated for impairment	<u>\$ 47,073</u>	<u>\$ 51,505</u>	<u>\$ 139,598</u>	<u>\$ 111,248</u>	<u>\$ 458,849</u>	<u>\$ 103,550</u>	<u>\$ 3,668</u>	<u>\$ 915,491</u>
	<b>As of and for the Year Ended December 31, 2020</b>							
	Real Estate Loans					Non-Real Estate Loans		Total
	Construction		Residential	Residential	Commercial	Commercial &	Consumer &	
	Residential	Commercial	Properties	Mortgage (1)		Industrial	Other	
	<i>(Dollars in thousands)</i>							
<b>Allowance for loan losses:</b>								
Beginning balance	\$ 219	\$ 201	\$ 602	\$ 634	\$ 2,363	\$ 841	\$ 71	\$ 4,931
Charge-offs	-	-	-	-	(152)	(3,347)	-	(3,499)
Recoveries	-	-	5	18	-	23	-	46
Provision (recovery)	75	78	192	139	863	3,688	5	5,040
Ending balance	<u>\$ 294</u>	<u>\$ 279</u>	<u>\$ 799</u>	<u>\$ 791</u>	<u>\$ 3,074</u>	<u>\$ 1,205</u>	<u>\$ 76</u>	<u>\$ 6,518</u>
Ending balance, individually evaluated for impairment	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
Ending balance, collectively evaluated for impairment	<u>\$ 294</u>	<u>\$ 279</u>	<u>\$ 799</u>	<u>\$ 791</u>	<u>\$ 3,074</u>	<u>\$ 1,205</u>	<u>\$ 76</u>	<u>\$ 6,518</u>
<b>Loans:</b>								
Ending balance	<u>\$ 45,051</u>	<u>\$ 46,701</u>	<u>\$ 118,575</u>	<u>\$ 94,269</u>	<u>\$ 427,812</u>	<u>\$ 219,209</u>	<u>\$ 3,247</u>	<u>\$ 954,864</u>
Ending balance, individually evaluated for impairment	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 467</u>	<u>\$ 119</u>	<u>\$ 1,997</u>	<u>\$ 1,035</u>	<u>\$ -</u>	<u>\$ 3,618</u>
Ending balance, collectively evaluated for impairment	<u>\$ 45,051</u>	<u>\$ 46,701</u>	<u>\$ 118,108</u>	<u>\$ 94,150</u>	<u>\$ 425,815</u>	<u>\$ 218,174</u>	<u>\$ 3,247</u>	<u>\$ 951,246</u>

(1) Single-family residential mortgages originated through NSB Mortgage, held for investment.

As of December 31, 2021 and 2020, respectively, due to the potential economic impact of COVID-19, the Bank has created a special

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purpose general reserve category to address loans that may have a collective heightened risk due to the industry in which they operate or from government-mandated closures and/or limitations. This general reserve was established using management's expectation of borrower performance and based upon a COVID-19 residual risk assessment surrounding the different industries in which the Company's borrowers operate. The COVID-19 general reserve contributed approximately \$1.2 million and \$1.3 million of the total \$6.7 and \$6.5 million allowance for loan losses as of December 31, 2021 and 2020, respectively.

**NOTE F - PREMISES AND EQUIPMENT**

The following table presents a summary of premises and equipment as of December 31, 2021, and 2020.

	As of December 31,	
	2021	2020
	<i>(Dollars in thousands)</i>	
Land	\$ 6,755	\$ 6,755
Buildings	20,562	20,869
Leasehold improvements	1,591	1,591
Furniture, fixtures and equipment	10,151	10,076
	<u>39,059</u>	<u>39,291</u>
Accumulated depreciation	<u>(16,442)</u>	<u>(16,373)</u>
Total	<u>\$ 22,617</u>	<u>\$ 22,918</u>

Depreciation expense totaled approximately \$1.1 million for both years ended December 31, 2021, and 2020, respectively, and is included in occupancy and equipment expense.

As the business case arises, assets may be sold or disposed of in the normal course of business. Net gains on sale or disposal are recognized in other income while net losses on sale or disposal are recognized in other expense. Losses on the disposal of fixed assets totaled approximately \$528,000 and \$139,000 for the year ended December 31, 2021, and 2020, respectively.

The Company leases office facilities under non-cancelable operating leases. The following table presents future minimum lease payments required under the leases as of December 31, 2021.

	For future years ending after December 31, 2021	
	<i>(Dollars in thousands)</i>	
2022	\$	689
2023		680
2024		695
2025		296
2026		165
thereafter		<u>595</u>
Total	<u>\$</u>	<u>3,120</u>

Building and equipment rental expense totaled approximately \$906,000 and \$959,000 for the years ended December 31, 2021, and 2020, respectively. Lease expense is included in occupancy and equipment expenses. The Company currently does not have any related party lease agreements. The leases have various lease terms and some of the leases have annual renewal options which are deemed probable.

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**NOTE G – DEPOSITS**

The aggregate amount of time deposits in denominations of \$250,000 or more as of December 31, 2021, and 2020, was approximately \$25.2 million and \$27.8 million, respectively.

The following table presents the scheduled maturities of time deposits as of December 31, 2021.

	As of December 31, 2021		
	Less than \$250,000	\$250,000 or more	Total
	<i>(Dollars in thousands)</i>		
2022	\$ 26,421	\$ 19,307	\$ 45,728
2023	5,527	3,595	9,122
2024	1,120	1,001	2,121
2025	2,042	962	3,004
2026	585	325	910
2028	1	-	1
	<u>\$ 35,696</u>	<u>\$ 25,190</u>	<u>\$ 60,886</u>

**NOTE H – SERVICING ASSETS**

Loans serviced for others are not included in the Company's consolidated balance sheets. The unpaid principal balances of the loans serviced for others was \$110.8 million and \$105.4 million as of December 31, 2021, and 2020, respectively. Servicing rights totaled \$1.9 million as of both December 31, 2021, and 2020, respectively, and are included under other assets on the Company's consolidated balance sheets. Amortization of servicing rights is based upon an effective yield method and can be accelerated by early loan payoffs. Amortization totaled approximately \$585,000 and \$329,000 for the years ended December 31, 2021, and 2020, respectively.

**NOTE I – BORROWINGS**

The following table presents a summary of borrowings as of December 31, 2021, and 2020.

	As of December 31,	
	2021	2020
	<i>(Dollars in thousands)</i>	
Short-term borrowings		
Repurchase agreements	\$ 239	\$ 319
	<u>\$ 239</u>	<u>\$ 319</u>
Long-term borrowings		
FHLB advances	\$ 518	\$ 548
Subordinated debentures	18,000	18,000
Junior subordinated debentures	15,465	15,465
Less debt issuance costs	410	457
Long-term borrowings, net	<u>\$ 33,573</u>	<u>\$ 33,556</u>

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The following table presents a summary of the trust preferred securities and related junior subordinated debentures outstanding as of December 31, 2021, and 2020.

	2021	2020	Maturity Date	Interest Rate
	<i>(Dollars in thousands)</i>			
North State Statutory Trust I	\$ 5,155	\$ 5,155	4/17/2034	3 mo LIBOR plus 2.79%, resets quarterly
North State Statutory Trust II	5,155	5,155	4/15/2035	3 mo LIBOR plus 1.65%, resets quarterly
North State Statutory Trust III	5,155	5,155	12/15/2037	3 mo LIBOR plus 2.75%, resets quarterly
	<u>\$ 15,465</u>	<u>\$ 15,465</u>		

The following table presents a summary of the subordinated debentures outstanding as of December 31, 2021, and 2020.

	2021	2020	Maturity Date	Interest rate
	<i>(Dollars in thousands)</i>			
Fixed-to-Floating rate subordinated notes	\$ 18,000	\$ 18,000	11/1/2030	Fixed 4.125% through November 1, 2025, thereafter, 3 mo SOFR plus 390.5 basis points, resets quarterly

**Short-term Borrowings**

The Company had \$239,000 and \$319,000, respectively, of repurchase agreements outstanding as of December 31, 2021 and 2020. Securities sold under agreements to repurchase generally mature within one to four days from the transaction date and are secured by \$1 million cash as of December 31, 2021 and 2020. These repurchase agreements are due within one year and are classified as short-term borrowings in the accompanying consolidated balance sheets. Interest rates for repurchase agreements vary from 0.00% to 0.05% as of December 31, 2021.

As of and throughout the years ended December 31, 2021 and 2020, the Company had no outstanding Federal Home Loan Bank (“FHLB”) short-term advances. Currently, any advances are secured by loans available for collateralization.

As of December 31, 2021, the Company had pre-approved available lines of credit totaling approximately \$323.1 million with various financial institutions and the Federal Reserve for borrowing on a short-term basis, with no amounts outstanding at that date. These lines are subject to annual renewals with varying interest rates.

**Long-term Borrowings**

As of December 31, 2021, and 2020, the Company had \$518,000 and \$548,000, respectively, outstanding balances in the form of long-term FHLB advances. These advances, fully maturing on October 7, 2025, fund a qualified Community Investment Program loan. The Company pays 2.00% interest for the advance with the loan earning 4.00%. This advance is secured by \$850,000 in cash as of December 31, 2021 and 2020.

On March 17, 2004, the Company issued \$5.2 million of junior subordinated debentures to North State Statutory Trust I (“Trust I”) in exchange for the proceeds of trust preferred securities issued by Trust I. On December 15, 2005, the Company issued \$5.2 million of junior subordinated debentures to North State Statutory Trust II (“Trust II”) in exchange for the proceeds of trust preferred securities issued by Trust II. On November 28, 2007, the Company issued \$5.2 million of junior subordinated debentures to North State Statutory Trust III (“Trust III”) in exchange for the proceeds of trust preferred securities issued by Trust III. The Company owns all the outstanding common securities of Trust I, Trust II and Trust III. The junior subordinated deferrable interest debentures are included in long-term borrowings and the Company’s equity interests in Trust I, Trust II and Trust III are included in other assets.

On November 20, 2015, the Company issued \$18 million of fixed-to-floating rate subordinated notes, maturing December 1, 2025 if not previously redeemed. Interest on the notes was 6.5% per annum through November 30, 2020 payable semi-annually in arrears. From December 1, 2020 until the maturity date or early redemption date, the interest rate resets quarterly to an interest rate per annum equal to the then current three-month LIBOR rate plus 487.5 basis points, payable quarterly in arrears. Interest on the subordinated

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notes was payable semi-annually on December 1 and June 1 of each year through December 1, 2020 and quarterly thereafter on March 1, June 1, September 1, and December 1 of each year through the maturity date or early redemption date. The first interest payment was made on June 1, 2016. The notes include redemption options for the Company beginning with the interest payment date of December 1, 2020 to redeem the subordinated notes in whole or in part upon giving required notice to the holders at a redemption price equal to 100% of the principal amount plus accrued and unpaid interest. Additionally, the Company has the option to redeem the notes due to a special event such as a change or prospective change in law that would prevent the deduction of the interest for federal tax purposes; or a subsequent event that could preclude the subordinated notes from being recognized as Tier 2 capital for regulatory capital purposes; or the Company could be required to register as an investment company. The subordinated notes are included in long-term borrowings and qualify as Tier 2 capital up to the redemption date. The Company furnished the required redemption notices and subsequently redeemed the \$18 million of fixed-to-floating rate subordinated notes at the Company's option on December 1, 2020. The result of this transaction included the repayment of \$18 million in principal along with accrued interest. Additionally, the Company recognized approximately \$310,000 of debt extinguishment costs related to the remaining capitalized debt issuance costs incurred during the initial debt offering.

On October 29, 2020, the Company issued \$18 million of fixed-to-floating rate subordinated notes, maturing November 1, 2030 if not previously redeemed. Interest on the notes is 4.125% per annum through November 1, 2025 payable semi-annually in arrears. From November 2, 2025 until the maturity date or early redemption date, the interest rate resets quarterly to an interest rate per annum equal to the then current three-month SOFR rate plus 390.5 basis points, payable quarterly in arrears. Interest on the subordinated notes is payable semi-annually on May 1 and November 1 of each year through November 1, 2025 and quarterly thereafter on February 1, May 1, August 1 and November 1 of each year through the maturity date or early redemption date. The first interest payment was made on May 1, 2021. The notes include redemption options for the Company beginning with the interest payment date of November 1, 2025 to redeem the subordinated notes in whole or in part upon giving required notice to the holders at a redemption price equal to 100% of the principal amount plus accrued and unpaid interest. Additionally, the Company has the option to redeem the notes due to a special event such as a change or prospective change in law that would prevent the deduction of the interest for federal tax purposes; or a subsequent event that could preclude the subordinated notes from being recognized as Tier 2 capital for regulatory capital purposes; or the Company could be required to register as an investment company. The subordinated notes are included in long-term borrowings and qualify as Tier 2 capital up to the redemption date. To qualify for Tier 2 capital, the subordinated notes must have an original weighted average maturity of at least five years and capital inclusion in Tier 2 capital will be discounted 20% each year after the remaining maturity is five years or less.

The junior subordinated debentures for Trust I pay interest quarterly at an annual rate, reset quarterly, equal to 3-month LIBOR plus 2.79%. The debentures became redeemable in whole or in part on June 17, 2009, and on any January 17, April 17, July 17, or October 17 thereafter. Redemption is mandatory on April 17, 2034. The Company has fully and unconditionally guaranteed the repayment of the trust preferred securities. The Company's obligation under the guarantee is unsecured and subordinate to senior and subordinated indebtedness of the Company.

The junior subordinated debentures for Trust II pay interest quarterly at an annual rate, reset quarterly, equal to 3-month LIBOR plus 1.65%. The debentures became redeemable in whole or in part on March 15, 2011, and on any January 15, April 15, July 15, or October 15 thereafter. Redemption is mandatory on April 15, 2035. The Company has fully and unconditionally guaranteed the repayment of the trust preferred securities. The Company's obligation under the guarantee is unsecured and subordinate to senior and subordinated indebtedness of the Company.

The junior subordinated debentures for Trust III pay interest quarterly at an annual rate, reset quarterly, equal to 3-month LIBOR plus 2.75%. The debentures are redeemable in whole or in part on March 15, 2013, and on any January 15, April 15, July 15, or October 15 thereafter. Redemption is mandatory on December 15, 2037. The Company has fully and unconditionally guaranteed the repayment of the trust preferred securities. The Company's obligation under the guarantee is unsecured and subordinate to senior and subordinated indebtedness of the Company.

Current Federal Reserve rules limit the aggregate amount of restricted core capital elements, including trust preferred securities that can be included in Tier 1 capital to not more than 25% of total core capital elements, net of goodwill, less any associated tax liability. Amounts of restricted core capital elements in excess of this limit may be included in Tier 2 capital. However, the aggregate amount of certain restricted core capital elements (including trust preferred securities), term subordinated debt and limited life preferred stock that can be included in Tier 2 capital is limited to 50% of Tier 1 capital.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") changed the ability of bank holding companies to issue trust preferred securities and continue to count them as Tier 1 capital. Bank holding companies with total

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assets of less than \$15 billion as of December 31, 2009, are permitted to include trust preferred securities issued before May 19, 2010, as Tier 1 capital. As such, the Company's existing trust preferred securities are grandfathered as Tier 1 capital under the Dodd-Frank Act.

**NOTE J - INCOME TAXES**

There were no uncertain tax positions as of December 31, 2021 or 2020. The Company changed tax status to an S Corporation effective January 1, 2016. The effect of an S Corporation is to eliminate corporate income tax. Corporate income, gains and losses are passed directly through to the shareholders of the Company in proportion to their per share ownership. As of January 1, 2021, the Company is no longer subject to corporate level taxation on unrealized built-in gains of \$3.4 million because the five-year period has fully lapsed. No federal income tax was recognized in 2020 on unrealized built-in gains.

**NOTE K – OTHER NON-INTEREST INCOME AND OTHER NON-INTEREST EXPENSE**

The following table presents the major components of non-interest income for the years ended December 31, 2021, and 2020.

	For the year ended December 31,	
	2021	2020
	<i>(Dollars in thousands)</i>	
Merchant and other loan fees	\$ 743	\$ 368
Service charges and fees on deposit accounts	283	279
Income from bank owned life insurance	301	267
Other	1,142	910
Total other non-interest income	<u>\$ 2,469</u>	<u>\$ 1,824</u>

The following table presents the major components of non-interest expense for the years ended December 31, 2021, and 2020.

	For the year ended December 31,	
	2021	2020
	<i>(Dollars in thousands)</i>	
Professional fees	\$ 698	\$ 738
Postage, printing & office supplies	205	242
Advertising and promotion	756	858
Telecommunications	556	445
Directors fees	860	928
FDIC insurance premiums	806	655
Mortgage processing costs	370	467
Donations	709	1,235
Loss on disposal of fixed assets	528	139
Other	1,988	2,142
Total other non-interest expense	<u>\$ 7,476</u>	<u>\$ 7,849</u>

**NOTE L - REGULATORY MATTERS**

The Bank, as a North Carolina banking corporation, may pay cash dividends to the Company only out of undivided profits as determined pursuant to North Carolina General Statutes Section 53-87. In conjunction with the Company's S Corporation election, the Bank has and intends to declare dividends to the Company in an amount sufficient for the Company to pay distributions to its shareholders. However, the Bank is subject to strict regulatory and legal guidelines regarding capital adequacy, dividend policies and other restrictions and rules. Regulatory authorities may limit payment of dividends by any bank when it is determined that such limitation is in the public interest and is necessary to ensure financial soundness of the bank. During the years ending December 31,



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2021, and 2020, the Bank distributed cash dividends to the Company of \$11.7 million and \$10.6 million, respectively.

The Company has and intends to declare distributions in an amount at least sufficient to enable shareholders to pay federal income tax and state income tax. The Company is dependent on dividends from the Bank and is subject to strict regulatory restrictions like the Bank. During the years ending December 31, 2021, and 2020, the Company declared cash distributions to shareholders of \$11.8 million and \$8.3 million, respectively.

The Bank is subject to various regulatory capital requirements administered by federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of its assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies. As of December 31, 2021, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum amounts and ratios. There are no conditions or events since that notification that management believes have changed the Bank's category.

In July 2013, the Federal Reserve Board approved and published the final Basel III Capital Rules establishing a new comprehensive capital framework for U.S. banking organizations. The Basel III Capital Rules, among other things, (i) introduce Common Equity Tier 1 ("CET1") as a new capital measure, (ii) specify that Tier 1 capital consists of CET1 and "Additional Tier 1 capital" instruments meeting specified requirements, (iii) define CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) expand the scope of the deductions from and adjustments to capital as compared to existing regulations. The Basel III Capital Rules were effective for the Bank on January 1, 2015 and are fully phased in as of December 31, 2021 and 2020. CET1 capital for the Bank consists of common stock, related paid-in capital, and retained earnings. In connection with the adoption of the Basel III Capital Rules, we elected to opt-out of the requirement to include most components of accumulated other comprehensive income in CET1. CET1 for the Bank is reduced by goodwill and intangible assets (intangible assets excluding MSAs and goodwill).

Basel III limits capital distributions and certain discretionary bonus payments if the banking organization does not hold a "capital conservation buffer" consisting of 2.50% of CET1 capital, Tier 1 capital and total capital to risk-weighted assets in addition to the amount necessary to meet minimum risk-based capital requirements. The capital conservation buffer was fully phased in as of January 1, 2019. Basel III requires (i) a minimum ratio of CET1 capital to risk-weighted assets of at least 4.50%, plus a 2.50% capital conservation buffer, (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.00%, plus the capital conservation buffer, (iii) a minimum ratio of total capital to risk-weighted assets of at least 8.00%, plus the 2.50% capital conservation buffer and (iv) a minimum leverage ratio of 4.00%.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios, as prescribed by regulations, of Total capital to risk-weighted assets, Tier I capital to risk-weighted assets, and CET 1 capital to risk-weighted assets, as well as Tier I capital to average assets. As of December 31, 2021, and 2020, the Bank met the respective capital adequacy requirements.

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The following table presents information regarding the Bank's capital and capital ratios as of December 31, 2021, and 2020, respectively.

	Actual		Minimum to be well capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio
<i>(Dollars in thousands)</i>				
As of December 31, 2021				
Total capital to risk-weighted assets	\$ 103,062	11.83%	\$ 87,143	10.00%
Tier I capital to risk-weighted assets	96,320	11.05%	69,714	8.00%
CETI to risk-weighted assets	96,320	11.05%	56,643	6.50%
Tier I capital to average assets	96,320	7.08%	68,055	5.00%
As of December 31, 2020				
Total capital to risk-weighted assets	\$ 96,904	11.60%	\$ 83,570	10.00%
Tier I capital to risk-weighted assets	90,386	10.82%	66,856	8.00%
CETI to risk-weighted assets	90,386	10.82%	54,320	6.50%
Tier I capital to average assets	90,386	7.71%	58,638	5.00%

The Bank had a capital conservation buffer of 3.83 percent as December 31, 2021. This buffer exceeded the 2.50 percent requirement and, therefore, results in no limit on distributions.

The Bank qualifies as a U.S. Department of Housing and Urban Development, or HUD, approved Title II supervised mortgagee and issues mortgages insured by HUD. For the years ended December 31, 2021, and 2020, the Bank was required to maintain \$1 million in baseline adjusted net worth plus an additional net worth of one percent of the total volume in excess of \$25 million of FHA single family insured mortgages originated, underwritten, purchased, or serviced during the prior fiscal year, up to a maximum required net worth of \$2.5 million. The Company complied with the net worth requirements as of December 31, 2021, and 2020.

**NOTE M – OFF-BALANCE SHEET RISK**

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of conditions established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company, upon extension of credit is based on management's credit evaluation of the borrower. Collateral obtained varies but may include real estate, stocks, bonds, and certificates of deposit. The liability related to off balance sheet commitments is not considered material as of December 31, 2021 or 2020.

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The following table presents a summary of the contractual amount of the Company's exposure to off-balance sheet credit risk as of December 31, 2021.

	<u>December 31, 2021</u>
	<i>(Dollars in thousands)</i>
Financial instruments whose contract amounts represent credit risk:	
Undisbursed lines of credit	\$ 178,123
Other commitments to extend credit	40,654
Letters of credit	2,157
Commitments to originate mortgage loans, fixed and variable	<u>23,504</u>
	<u>\$ 244,438</u>

**NOTE N - FAIR VALUE MEASUREMENTS**

The Company utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available-for-sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record other assets at fair value on a nonrecurring basis, such as impaired loans, servicing assets, and foreclosed assets. The nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets. The Company groups its financial assets and financial liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded, and the reliability of the assumptions used to determine fair value. These levels are:

- Level 1 – Valuations for assets and liabilities traded in active exchange markets, such as the New York Stock Exchange. Level 1 also includes U.S. Treasury, other U.S. government and agency mortgage-backed securities that are traded by dealers or brokers in active markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.
- Level 2 – Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third party services for identical or comparable assets or liabilities.
- Level 3 – Valuations for assets and liabilities that are derived from other valuation methodologies, including option pricing models, discounted cash flow models and similar techniques, and not based on market exchange, dealer, or brokered facilitated transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities.

***Valuation of Assets and Liabilities Reported at Fair Value in Financial Statements***

The fair value of a financial instrument is the estimated amount at which the instrument could be exchanged in an orderly transaction between knowledgeable, unrelated, willing parties. The estimated fair value of a financial instrument may differ from the amount that could be realized if sold in an immediate sale such as a forced transaction. Additionally, the valuation of investments is more subjective when markets are less liquid due to the lack of market-based inputs, which may increase the potential that the estimated fair value of an investment is not reflective of the price at which an actual transaction would occur.

Securities available-for-sale and interest rate lock commitments are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record other assets at fair value on a nonrecurring basis, such as impaired loans, servicing assets, and foreclosed assets. The nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

The following is a description of valuation methodologies used by the Company for assets and liabilities recorded at fair value, either on a recurring or nonrecurring basis.

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***Investment Securities Available for Sale***

Investment securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds, and corporate debt securities.

***Mortgage Banking Activity***

The Company enters into interest rate lock commitments and commitments to sell mortgages. Changes in the interest rate lock commitments subjected to recurring fair value adjustments are affected by changes in fallout rates and changes in the prevailing secondary market prices for like-kind mortgage loans. Additionally, the fair value of interest rate lock commitments is based on servicing rate premium, origination income net of originations costs, and changes in loan pricing between the commitment date and period end, typically month end. The fallout rate measures the likelihood that an interest rate lock commitment will ultimately not become a closed loan held for sale. Factors contributing to the fallout rate include changes in prevailing interest rates from the time of the interest rate lock commitment as well as other factors such as lower than anticipated appraised values. As of December 31, 2021, the fallout rate averaged approximately 8% and the amount of fair value associated with these interest rate lock commitments was approximately \$555,000. As of December 31, 2020, the fallout rate averaged approximately 12% and the amount of fair value associated with these interest rate lock commitments was approximately \$1.47 million. The fair value associated with interest rate lock commitments is included in other assets.

***Loans***

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as impaired, management measures the impairment in accordance with accounting standards. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value or discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. As of December 31, 2021, the Company's impaired loans were evaluated primarily based on the fair value of the collateral. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3. The unobservable inputs include collateral discounts in a range of 5% to 20% of appraised value. The valuation techniques for the Level 3 impaired loans are consistent with techniques used in prior periods.

***Foreclosed Assets***

Foreclosed assets are adjusted to fair value, less estimated costs to sell, upon transfer of the loans to foreclosed assets. The initial recorded value may be subsequently reduced by additional valuation allowances, which are charged to earnings if the estimated fair value of the property less estimated selling costs declines below the initial recorded value. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the foreclosed asset as nonrecurring Level 3. The unobservable inputs include collateral discounts in a range of 5% to 20% of appraised values as well as an estimated cost to sell range of 6% to 8%. The valuation techniques for the Level 3 foreclosed assets are consistent with techniques used in prior periods.

***SBA Servicing Rights***

SBA servicing rights are initially recorded at fair value when loans are sold with servicing retained. These assets are then amortized in proportion to and over the period of estimated net servicing income. The servicing rights are periodically evaluated for impairment based upon the fair value of the servicing rights compared to their respective carrying amounts. The Company estimates the fair value of its servicing rights using discounted cash flow models incorporating numerous assumptions from the perspective of a market

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participant including servicing income, servicing costs, market discount rates and prepayment speeds. As a result of the valuation inputs, servicing rights are classified within Level 3 of the valuation hierarchy.

The following table presents the balances of assets and liabilities measured at fair value on a recurring basis as of December 31, 2021, and 2020, respectively.

	As of December 31, 2021			
	Total	Level 1	Level 2	Level 3
	<i>(Dollars in thousands)</i>			
Securities available for sale:				
Government-sponsored residential mortgage-backed securities	\$ 4,252	\$ -	\$ 4,252	\$ -
Total securities available for sale	<u>\$ 4,252</u>	<u>\$ -</u>	<u>\$ 4,252</u>	<u>\$ -</u>
Interest rate lock commitments	<u>\$ 555</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 555</u>
	As of December 31, 2020			
	Total	Level 1	Level 2	Level 3
	<i>(Dollars in thousands)</i>			
Securities available for sale:				
Government-sponsored residential mortgage-backed securities	\$ 1,118	\$ -	\$ 1,118	\$ -
Total securities available for sale	<u>\$ 1,118</u>	<u>\$ -</u>	<u>\$ 1,118</u>	<u>\$ -</u>
Interest rate lock commitments	<u>\$ 1,465</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,465</u>

The following table presents all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the years ended December 31, 2021, and 2020.

	For the year ended December 31,	
	2021	2020
	<i>(Dollars in thousands)</i>	
Balance, beginning of year	\$ 1,465	\$ 388
(Losses) gains included in other income	(910)	1,077
Balance, end of year	<u>\$ 555</u>	<u>\$ 1,465</u>

The Company may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis in accordance with U.S. generally accepted accounting principles. These include assets that are measured at the lower of cost or market that were recognized at fair value when fair value fell below the carrying amount as of the end of the period under measurement.

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The following table presents the balances of assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2021, and 2020, respectively.

	As of December 31, 2021			
	Total	Level 1	Level 2	Level 3
	<i>(Dollars in thousands)</i>			
Impaired loans	\$ 221	\$ -	\$ -	\$ 221
Servicing assets	\$ 1,865	\$ -	\$ -	\$ 1,865

	As of December 31, 2020			
	Total	Level 1	Level 2	Level 3
	<i>(Dollars in thousands)</i>			
Servicing assets	\$ 1,918	\$ -	\$ -	\$ 1,918

**NOTE O - EMPLOYEE AND DIRECTOR BENEFIT PLANS**

***401(k) and ESOP Retirement Plan***

The Company has maintained a qualified 401(k) plan for regular full or part-time employees since June 1, 2000. On January 1, 2015, the Company amended its 401(k) plan and adopted a combined 401(k) and Employee Stock Ownership Plan (“ESOP”). The plan as amended consists of two components (1) a qualified stock bonus plan (ESOP component) and (2) a qualified cash or deferred arrangement, of which no part of can be invested in Company stock, (401(k) component). The purposes of the plan, as restated, are to enable eligible employees to (a) contribute up to an annual maximum as determined under the Internal Revenue Code, (b) share in the growth and prosperity of the Company, (c) accumulate capital for their future economic security, and (d) acquire beneficial stock ownership interests in the Company. The Company matches 100% of employee contributions, not exceeding 6% of the participants’ compensation, by contributing to the ESOP component of the plan, which is invested in Company stock. In addition, the board of directors can authorize additional discretionary contributions to the plan. The plan provides that employees’ contributions are 100% vested at all times. Company contributions are 100% vested for the years beginning on or after January 1, 2008. The expense related to the 401(k) and ESOP plan contributions for the years ended December 31, 2021 and 2020 totaled approximately \$1.0 million and \$924,000, respectively.

***Employment Agreements***

The Company has entered into an employment agreement with its chief executive officer to ensure a stable and competent management base. This agreement provides for benefits as spelled out in the contract and cannot be terminated by the Board of Directors, except for cause, without prejudicing the officer’s right to receive certain vested rights, including compensation. In the event of a change in control of the Company, as outlined in the agreement, the acquirer will be bound to the terms of this contract.

In addition, the Company entered into a “separation benefit agreement” during July 2012 with its chief executive officer. The benefit vests monthly over 72 months beginning July 31, 2012. Also, the Company entered into an additional “separation benefit agreement” with its chief executive during 2017 with a five-year vesting period beginning January 1, 2017. During 2013 and 2015 the Company entered into “separation benefit and executive bonus agreements” with select officers of the Company. Total compensation expense related to all the separation and bonus agreements totaled approximately \$67,000 and \$422,000, respectively, for the years ended December 31, 2021 and 2020. The liability related to the “separation benefit agreements” was \$3.1 million and \$3.1 million, respectively, as of December 31, 2021 and 2020. The agreements provide for benefits as described in the contracts.

The Company has entered into agreements with four executive officers and one non-executive officer that provides for severance pay benefits in the event of a change in control of the Company that results in the termination of such officers or diminished compensation, duties, or benefits.

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**NOTE P - PARENT COMPANY FINANCIAL DATA**

The following tables present the condensed financial statements of North State Bancorp as of and for the years ended December 31, 2021, and 2020, respectively.

Condensed Statements of Financial Condition  
December 31, 2021 and 2020

	2021	2020
	<i>(Dollars in thousands)</i>	
<b>Assets</b>		
Cash and due from banks	\$ 1,141	\$ 1,197
Investment in North State Bank	96,745	90,746
Investment in North State Statutory Trust I	155	155
Investment in North State Statutory Trust II	155	155
Investment in North State Statutory Trust III	155	155
Other assets	3	125
<b>Total Assets</b>	<b>\$ 98,354</b>	<b>\$ 92,533</b>
<b>Liabilities and Shareholders' equity</b>		
Other liabilities	\$ 143	\$ 266
Long-term borrowings	33,054	33,007
<b>Shareholders' equity</b>		
Common stock	11,215	9,668
Retained earnings	53,973	49,579
Accumulated other comprehensive (loss) income	(31)	13
<b>Total shareholders' equity</b>	<b>65,157</b>	<b>59,260</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 98,354</b>	<b>\$ 92,533</b>

Condensed Statements of Operations  
Years Ended December 31, 2021 and 2020

	2021	2020
	<i>(Dollars in thousands)</i>	
Equity in undistributed earnings of bank subsidiary	\$ 6,043	\$ 7,063
Dividends received from bank subsidiary	11,672	10,610
Interest income	12	15
Interest expense	(1,190)	(2,065)
Other expense	(382)	(375)
<b>Net income</b>	<b>\$ 16,155</b>	<b>\$ 15,248</b>

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Condensed Statements of Cash Flows  
Years Ended December 31, 2021 and 2020

	2021	2020
	<i>(Dollars in thousands)</i>	
Cash flows from operating activities:		
Net income	\$ 16,155	\$ 15,248
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization	47	67
Proceeds from issuance of common stock to ESOP	1,032	924
Issuance of common stock for board compensation	515	408
Equity in undistributed earnings of subsidiary	(6,043)	(7,063)
Loss on debt extinguishment	-	310
Changes in assets and liabilities:		
Decrease in other assets	122	250
Decrease in other liabilities	(123)	(234)
Net cash provided by operating activities	<u>11,705</u>	<u>9,910</u>
Cash flows from financing activities:		
Repayments of long-term borrowings	-	(18,000)
Issuance of subordinated debt, net of issuance costs	-	17,549
Cash distributions to shareholders	(11,761)	(8,330)
Net cash used in financing activities	<u>(11,761)</u>	<u>(8,781)</u>
Net (decrease) increase in cash and cash equivalents	(56)	1,129
Cash and cash equivalents, beginning	1,197	68
Cash and cash equivalents, ending	<u>\$ 1,141</u>	<u>\$ 1,197</u>



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**NOTE Q – BUSINESS SEGMENT INFORMATION**

The Company has four reportable business segments, the Bank, NSB Mortgage, SBA, and the parent Company. The Bank is engaged in general commercial and retail banking in central and coastal North Carolina. The Bank operates six full-service banking offices located in Wake County and one full-service office in Wilmington, New Hanover County, North Carolina. NSB Mortgage, a division of the Bank, originates and sells single-family residential first mortgage loans. SBA, another division of our Bank, originates and sells loans (generally 75%) guaranteed by the Small Business Administration. The remaining segment consists of activities of the parent Company. Eliminations necessary to accurately report the operations of the Company are also included.

The following table presents selected segment reporting information as of and for the years ended December 31, 2021, and 2020, respectively.

	As of or for the Year Ended December 31, 2021					
	Bank	NSB Mortgage	SBA	Parent Company	Eliminations	Total Company
	<i>(Dollars in thousands)</i>					
Interest income	\$ 32,894	\$ 1,974	\$ 9,427	\$ 12	\$ -	\$ 44,307
Interest expense	2,215	-	7	1,190	-	3,412
Net interest income	30,679	1,974	9,420	(1,178)	-	40,895
Provision for loan losses	-	-	-	-	-	-
Net interest income after provision for loan losses	30,679	1,974	9,420	(1,178)	-	40,895
Noninterest income	2,128	12,145	3,266	-	-	17,539
Noninterest expense	29,939	9,478	2,480	382	-	42,279
Net income (loss)	\$ 2,868	\$ 4,641	\$ 10,206	\$ (1,560)	\$ -	\$ 16,155
Total assets	\$ 1,232,013	\$ 87,074	\$ 76,300	\$ 98,354	\$ (97,886)	\$ 1,395,855
Net loans	758,918	78,505	73,817	-	-	911,240
Loans held for sale	-	7,218	-	-	-	7,218
Goodwill	-	141	-	-	-	141
	<i>(Dollars in thousands)</i>					
	As of or for the Year Ended December 31, 2020					
	Bank	NSB Mortgage	SBA	Parent Company	Eliminations	Total Company
	<i>(Dollars in thousands)</i>					
Interest income	\$ 34,015	\$ 2,342	\$ 6,411	\$ 15	\$ -	\$ 42,783
Interest expense	2,773	-	5	2,065	-	4,843
Net interest income	31,242	2,342	6,406	(2,050)	-	37,940
Provision for loan losses	5,040	-	-	-	-	5,040
Net interest income after provision for loan losses	26,202	2,342	6,406	(2,050)	-	32,900
Noninterest income	1,945	20,030	2,967	-	-	24,942
Noninterest expense	27,793	11,046	3,380	375	-	42,594
Net income (loss)	\$ 354	\$ 11,326	\$ 5,993	\$ (2,425)	\$ -	\$ 15,248
Total assets	\$ 934,594	\$ 72,772	\$ 164,787	\$ 92,533	\$ (91,943)	\$ 1,172,743
Net loans	747,225	39,690	161,431	-	-	948,346
Loans held for sale	-	27,500	-	-	-	27,500
Goodwill	-	141	-	-	-	141